Section II
RECOMMENDATIONS

The research findings, based on the interviews of organizations active in community development, the analysis of lending patterns in the region, and the survey of small businesses, describe a situation where certain communities have more difficulty in obtaining capital for homeownership, housing rehabilitation, affordable housing development, and small business development.

The possible reasons homebuyers, affordable housing developers, and small businesses attract fewer loans in low- and moderate-income communities are numerous. Not all of the reasons, however, are attributable to the lack of available loan capital. According to the comments of organizations active in affordable housing and community development, and as implied in the small business survey, debt capital appears readily available in today's market under standard underwriting criteria. Despite this availability of debt capital, the analysis of lending patterns shows pockets of neglect.

Other factors, therefore, may explain the relatively fewer loans in low- and moderate-income communities despite the general availability of debt capital. These factors are potentially important impediments to obtaining capital in the region's low- and moderate-income communities:

- Many low- and moderate-income, first-time homebuyers have difficulty qualifying for available loans due to the high cost of housing relative to their qualifying incomes, a lack of financial knowledge and understanding of how the loan process works, and difficulty in meeting the standard equity and debt coverage requirements. Several reports have addressed the high cost of housing specifically, including the City of San Diego's Land Use & Housing Technical Advisory Committee's report on Housing Affordability (1997), and the region's various consolidated plans and housing elements.

- Affordable housing developers, whether non-profit or for-profit, have difficulty obtaining the equity funds, pre-development capital, and bridge loans to build more affordable housing to meet regional demand. While there are approximately 25 non-profit entities pursuing or considering affordable housing developments, only a few have significant experience and have built most of the projects. More entities, particularly community development corporations, would be more active in affordable housing development if they had the capacity and technical expertise. Many developers of affordable housing report difficulty finding affordable land on which to build low- and moderate-income housing.

- The lower rate of small business-loans in low- and moderate-income communities is in large part attributable to the lack of total businesses in the 11- to 50-employee size range. Firms in this size category usually are somewhat established rather than new start-up ventures, and often are poised for growth, and therefore seek loans. The slightly lower proportion of these types of firms in low- and moderate-income communities, despite the relatively greater number of total businesses per tract that exist in these communities, may be explained by other factors than the lack of access to debt capital. Other possible reasons may include inadequate land and facilities to support these firms; a tendency for firms to cluster in major employment centers that are not located within low- and moderate-income communities; the preference for business owners to locate their operations closer to where they live; the perceived higher cost of operating in older communities; and other factors.

- Businesses that have fewer than 11 employees comprise most of the small businesses in the region. An increasing number are home-based. Given that the number or proportion of businesses in this size category are not significant variables for predicting loan volume by location, it appears that small businesses are not major loan customers of the products that CRA-regulated banks currently provide in the region.

- While the relatively lower proportion of businesses in the 11- to 50-employee size category is an important factor, it is not the only factor. The rate of small business-loans in low- and moderate-income communities is still below average, even after controlling for firm size. Some of the possible reasons include inadequate marketing of loan products in these communities, cultural barriers that discourage communication between some small business owners and lenders, a cultural bias against debt among some ethnic groups, a lack of understanding of financing among many small business owners, greater difficulty in obtaining equity or providing collateral, and other reasons.

- The greater difficulty in funding start-up companies and growth in low- and moderate-income communities may also contribute to the shortage of larger established businesses, and, therefore, fewer business loans. Due to the fewer financial resources available to many would-be entrepreneurs in low- and moderate-income communities, it is difficult for potential entrepreneurs to accumulate equity. It is difficult to attract venture capital due to the relatively small business volume associated with the types of businesses undertaken, the perceived greater market risk in these communities, and the limited upside rate-of-return potential compared to other opportunities those with venture capital seek.

- Finally, while debt capital may be available in today's market, and more efficient to obtain for conventionally qualified applicants, the delivery system to low- and moderate-income communities could be improved. The delivery system is in transition as the number of full-service branches in low- and moderate-income communities declines due to bank consolidations and greater reliance on technology. Without a knowledgeable branch manager within the community, it is more difficult for lenders to consider applicant character and other project or market nuances as factors that may compensate for weaknesses in collateral and credit history, which is often the case with marginal applicants in low- and moderate-income communities. There may be institutional disincentives to aggressively promote and process loans in low- and moderate-income communities, because of the relatively high transaction cost of lending in these areas, structuring complicated projects, and working with marginal applicants. It is more profitable for banks and loan officers to spend less time with standard applicants seeking higher value loans, than to spend more time with marginal applicants seeking lower value loans.

RECOMMENDATIONS

As input to the San Diego City/County Task Forces' Three-Year Master Plan, the consultant team recommends the following actions to help address some of the issues identified in this study. These recommended actions are in addition to and supportive of the Task Force's primary role of monitoring and negotiating Community Reinvestment Act compliance. They are input to the San Diego City/County Task Force's Three Year Master Plan, but they alone do not make a master plan, which is beyond the scope of this study. A master plan should also set priorities, present the organizational structure to implement the selected priorities, and describe how the organization will be funded to carry out its efforts.

ACTIONS TO ENCOURAGE REINVESTMENT IN SMALL BUSINESS DEVELOPMENT

Need: **Many low- and moderate-income communities do not have enough firms employing 11-50 employees, particularly in the manufacturing, warehouse/distribution, and business service sectors; consequently, their share of small business-loans is relatively low.**

Action 1: The RTF should support efforts to include and upgrade competitive employment generating land uses and urban employment-center growth within appropriate low- and moderate-income communities. Possibly working with the various economic development corporations in the region, the RTF should encourage site selection assistance for small businesses to locate in designated low- and moderate-income tracts. Selected existing small businesses in middle- and high-income communities that are being displaced by rising rents present an opportunity.

Need: **Many businesses are unaware of available loan products and technical services, and many banks and investors are unaware of business opportunities in low- and moderate-income communities.**

Action 2: Working with existing organizations that are already undertaking the initiative, support an internet information clearinghouse and matchmaker network that specifically targets small businesses in low and moderate income communities. The Internet service would provide information and links to small businesses about available loan products, government and non-profit assistance, and professional services. Conversely, the service would provide a list of potential business clients to lenders, investors, and service providers. The Task Force can help provide content and encourage links for the service. ***CRA regulated banks may receive service credit for providing technical assistance in establishing the web site, or investment credit for providing grants to a qualified non-profit to establish the web site.***

Action 3: Facilitate linkages between existing ethnic and community-based chambers of commerce, business associations, the growing number of business improvement districts associations, and lenders, non-profit technical assistance providers, and for-profit business service firms.

Need: **Relatively higher transaction costs associated with small business lending in low- and moderate-income communities may discourage lending. Transaction costs should be reduced if possible.**

Action 4: Work with appropriate lending institutions to provide small business-loans, micro-loan products, and credit-card debt consolidation loans in targeted communities through existing or newly established development banks, bank consortiums, or other intermediaries whose charge is to market and originate small business loans in low- and moderate-income communities. Encourage banks to provide compensation incentives to loan officers to originate loans in targeted under-served communities. ***CRA regulated banks may get investment credit for investing in qualified non-profit organizations, or loan credits for making or purchasing qualified loans.***

Need: **Many small businesses in low- and moderate-income communities find it difficult to obtain adequate start-up and growth-equity capital.**

Action 5: Study the feasibility of enhancing existing or creating new small business loan and investment programs that provide or leverage lower-cost small business loans, under more affordable and patient terms to targeted minority-owned businesses and businesses within low- and moderate-income communities. The programs may provide capital directly, or support loan guarantees. The purpose of these favorable loans is to leverage additional private investment by writing down the average cost of financing, absorbing extra risk, and increasing capitalization. These programs may be funded with Community Development Block Grants other potential Federal and State grants, and private foundation grants. Loans that are paid are recycled, thereby leveraging the effectiveness of the initial grant dollars. ***CRA regulated banks may get investment credit for providing grants to or investing in qualified non-profits established for such***

purposes, service credits for providing technical assistance to such organizations, or loan credits for making or purchasing such loans.

Action 6: Explore the possibility of a private, non-profit equity capital fund that targets selected early stage business. The fund would invest smaller amounts than do venture capital funds in early-stage business that are willing to locate in low- and moderate-income communities, in order to leverage additional private for-profit investment. The Pittsburgh Gateways Corporation is an example of this type of fund. ***CRA regulated banks could receive investment credit for providing grants to such a fund or a line-of-credit for operations.***

Action 7: Encourage and assist the region's existing special financial intermediaries that target small business investments to low- and moderate-income communities to better access Federal sponsored equity and loan programs, and more effectively leverage their existing capital while providing a critical mass of resources. These programs include Small Business Investment Corporations (SBICs), Specialized Small Business Investment Companies, Community Development Financial Institution (CDFI) Funds, SBA Micro Loans, CDBG, and others. Support greater targeting of Federal (and proposed State) investment capital resource programs to low- and moderate-income communities. In particular, support elimination of the safe harbor SBICs currently receive from any required minimum level of investment in low- and moderate-income communities.

Action 8: Prepare a case study of how the Asian key funds work and present this study to ethnic and community business groups throughout the region.

Need: **Many small businesses in low- and moderate-income communities need financial training and counseling.**

Action 9: Encourage banks to work with existing technical assistance organizations, small business organizations, business improvement district organizations, and community-based development organizations to provide technical assistance. ***CRA regulated banks may receive service credit for providing technical assistance directly, in partnership with***

existing organizations, or in providing grants to qualified non-profit technical assistance and counseling organizations.

ACTIONS TO ENCOURAGE REINVESTMENT FOR AFFORDABLE HOUSING

For Home Purchase and Improvement

Need: **Many potential low- and moderate-income homebuyers are unfamiliar about financial planning and the loan application process.**

Action 10: Establish funding targets for multi-lingual homebuyer counseling programs for low- and moderate-income families, negotiate bank and mortgage lender participation, and apply for government and foundation grants. ***CRA regulated banks may get CRA technical assistance credit for providing counseling services directly, or investment credit for funding qualified non-profits that provide homebuyer counseling.***

Action 11: Work with housing agencies and existing non-profit organizations to enhance homebuyer assistance office hours in existing community centers in selected low- and moderate-income communities. Fund these services with grants. Work with lenders through the annual review of CRA plans to fund homebuyer assistance programs. ***CRA regulated banks may get CRA investment credit for funding qualified non-profit organizations, and loan credit if a loan applicant is referred to the bank and the bank provides the loan.***

Need: **The relatively higher transaction costs for homebuyer loans in low- and moderate-income communities discourage aggressive marketing by lending institutions that provide home loans. Transaction costs should be reduced.**

Action 12: Select or help form qualified community-based intermediaries, such as a development bank, bank consortium intermediary, or other non-bank intermediary lenders to target and aggressively market low- and moderate-income communities. Through these organizations, develop flexible underwriting terms, and originate home purchase and home improvement loans on behalf of participating banks and other mortgage lenders.

Review the most efficient type of organization for marketing and originating loans in low- and moderate-income communities, and help build the capacity of the more effective organizations. Continue efforts to simplify and standardized loan application forms that agencies, intermediaries, and lenders can use. Encourage banks and other mortgage lenders to provide compensation incentives to loan officers to originate loans in targeted under-served communities. ***CRA regulated banks may get investment credit for investing in qualified non-profit intermediary organizations, service credit for providing technical assistance to these organizations, or loan credit if an intermediary refers a loan application to the bank for the final approval and funding.***

Need: **Many families and low- and moderate-income communities cannot obtain qualifying equity.**

Action 13: Work with development banks, bank consortiums, loan pools, and individual bank and housing agency community lending programs to encourage more flexible underwriting criteria. Loans that are not retained by the originator must still be structured to be saleable. Examples of flexible criteria include lower down-payment requirements, recognition of sweat-equity, lease-purchase programs, higher debt-income ratios for those living near major transit centers (thereby reducing the need for an additional car payment), and other programs. ***CRA regulated banks may get service test credit for developing innovative loan products, and loan credit for making a loan with an innovative product or buying a loan originated with an innovative loan product.***

<u>For Affordable Housing Development</u>

Need: **The high cost of land and housing in the San Diego region makes affordable housing more difficult to develop. Reduce the cost of housing.**

Action 14: Work with local governments, community groups, and developers to formulate alternative financing strategies for funding public improvements required by new low- and moderate income households, so as to reduce or defer impact fees for low- and moderate-income housing. Encourage member government agencies to expedite the approval process for qualified low- and moderate-income housing, and adjust fee payment schedules to reduce up-front costs and improve cash flow.

Action 15: Encourage mixed-use development to reduce costs per unit. Work with public agencies to reduce parking requirements for affordable housing near public transit corridors and in mixed-use projects where parking can be shared. Work with transit agencies and local jurisdictions to include affordable housing within transit-oriented development projects. Work with financial institutions to establish special loan pools for mixed-use development that includes affordable housing. ***CRA regulated banks may get service test credit for creating innovative loan products for mixed-use development with affordable housing, investment credit for funding such a loan pool, or loan credit for making decisions to fund such loans directly.***

Action 16: Research the potential for establishing a private, non-profit Low-Income Housing Land Trust to buy options on land and individual infill lots for affordable housing when prices are low, parcels are available, or tax lien properties are available. Write down land costs in selected situations. The Trust would later transfer the parcels to affordable housing developers when their financing, tax credit approvals and entitlements are in place. The Trust may also work with a "move-on" program, where older homes that would otherwise be demolished could be moved onto Trust properties and rehabilitated. The Trust may be funded initially by government grants, negotiated bank donations, foundation grants, and low-income housing in-lieu fees under inclusionary housing programs. ***CRA regulated banks could get investment credit for providing grants to a qualified non-profit, and service credit for providing technical assistance.***

Action 17: Develop strategies with appropriate government agencies and mortgage lenders to secure accessible mortgage credit for condominium purchase in condo complexes with less than fifty percent owner occupancy, and homeownership programs for existing low- and moderate-income tenants in selected publicly-owned and non-profit rental properties. ***CRA regulated banks could get loan credit for providing such loans to qualified homebuyers.***

Action 18: Develop strategies with appropriate government agencies and mortgage lenders to secure and market accessible mortgage credit for home improvement loans to improve existing housing stock in low- and moderate-income communities. ***CRA regulated banks could get loan credit for providing such loans to qualified homebuyers.***

Need: **The limited public funds available for financially assisting low- and moderate-income housing development constrains the amount of affordable housing that could be developed.**

Action 19: Now that the recession is over, encourage the City of San Diego to restore the original commitment to the City of San Diego Housing Trust Fund. Encourage the formation of a similar fund to serve other jurisdictions in the region.

Action 20: Work with Fannie Mae and Freddie Mac to create an affordable housing capital fund for the San Diego region. Encourage Fannie Mae and Freddie Mac to require that a proportional share of mortgage loans originated by mortgage banks and brokers, which are sold to CRA-regulated banks, occur in low- and moderate-income communities. Review Fannie Mae credit scoring standards and how they encourage or discourage lending in low- and moderate-income communities.

OTHER ACTIONS

Need: **Measurable criteria for monitoring CRA compliance for both affordable housing and small business loans.**

Action 21: Identify HMDA and CRA lenders that have branches in the region and their respective assessment areas. Identify how much of their portfolio is comprised of qualified loan originations and loan purchases. Negotiate lending goals for originations and purchases of loans in low- and moderate-income communities, and for low- and moderate-income borrowers. These goals should be stated as a percentage of loans and loan volume within each lender's assessment area and monitored annually. ***CRA regulated banks would receive loan credits for originating targeted loans.***

Action 22: Support changes to CRA regulation and Regulation B to permit banking institutions to gather information regarding the race, ethnicity, sex, and type of business for the small business loan customer. This data should be included as part of banks' annual CRA submissions. Also, support changes to the CRA to give credit for loans of any size in low- and moderate-income census tracts.

Need: **Better communication and coordination among community-based development organizations, small business development organizations, affordable housing organizations, and lenders to coordinate community development efforts.**

Action 23: Work with banks and non-profit groups to sponsor an annual forum or summit of the above organizations throughout the region to discuss best practices, lessons learned, emerging issues, and the relationships between affordable housing, small business, and general community development.

Action 24: Encourage financial institutions active within the region to partner with a selected community development corporation, BID, or similar entity to encourage mutual interaction, technical assistance from the financial institution to the non-profit, community knowledge from the non-profit to the financial institution, and possibly a loan fund. ***CRA regulated banks may get service credit for providing technical assistance to these organizations, and investment credit for providing grants to these organizations.***

Need: **Improve links between community economic development efforts and regional economic development efforts to ensure that the whole region participates in San Diego's economic prosperity.**

Action 25: Work with regional economic development agencies to fund a study of industry composition, by firm size, within low- and moderate-income communities in the region, and assess how their industry profile compares to the profile in middle- and high-income communities. Evaluate how the industry profile in low- and moderate-income communities relates to the regional economic prosperity strategy and its targeted industry clusters.

IMPLEMENTATION

Most of the recommended actions can be implemented through existing organizations and structures in the county, with the San Diego City/County Reinvestment Task Force playing a coordination role. Other than the City/County Reinvestment Task Force and the CRA-regulated banks themselves, there are seven types of organizations and structures required, as follows:

1. Community-based development banks
2. Bank loan pools or consortiums represented by intermediaries
3. Targeted loan funds
4. Equity capital funds
5. Financial counseling organizations
6. Affordable housing trusts
7. Community-based development organizations

The development bank is a chartered bank, whose shareholders include other financial institutions and investors. The purpose of the development bank is to seek out lending opportunities in targeted situations, such as low- and moderate-income communities or among specific under-served minority groups. The risk is shared among the stockholders. The bank provides bank stockholders a local presence, knowledgeable staff, and a vehicle for marketing which bank-stockholders might not be able to provide on their own.

A bank consortium is more informal. It is a loan pool funded by member banks to provide potentially higher-risk loans with more flexible underwriting criteria than member banks normally allow. The consortium is organized to address specific situations, such as lower value small-business loans in low- and moderate-income communities, more complicated affordable housing projects, higher risk mortgages for low-income households, etc. Member banks share the risk, in proportion to their contribution to the pool, or the loan opportunities are distributed among the member banks according to some agreed criteria. An experienced intermediary entity often markets the loans, administers the loan pool, and/or packages the loans for the consortium members, which reduces the transaction costs for members, overcoming one of the barriers to lending activity in low- and moderate-income areas. Banks can potentially get CRA credit on three counts – technical assistance credit to a non-profit intermediary, investment credit for funding the intermediary's operating expenses, and loan credit for participation in loans funded by the pool.

Targeted loan fund programs are organized by governments, non-profit organizations, and financial institutions to provide patient and lower cost capital in situations that the banking and investment communities are not or cannot address under their normal policies. These funds may include high-risk small business loans in targeted communities; a reserve for loan guarantees; loans that require more patient terms than normal bank policy can provide; loans that can be converted to equity; unsecured loans without personal guarantees; micro-loans; loans to targeted minority groups; assistance to near start-ups; loans for mixed-use development with affordable housing; flexible underwriting criteria, etc. These loans are either direct or subordinated to more conventional bank loans. The risk is often high, and the fund's rate-of-return criteria is low, a risk-reward formula that the private for-profit sector cannot normally accept. Staff is trained specifically for these types of loan programs, many through the National Development Council programs.

Equity capital funds provide investment equity to targeted business, such as minority businesses, businesses agreeing to locate in targeted areas, and businesses in targeted industries. These are public purpose, private equity funds capitalized by private investments and foundation grants. Some receive financial assistance from Federal programs. They leverage additional private investment by absorbing some of the extraordinary risk. While they have the same focus on entrepreneurship as other equity capital funds, they are willing to invest smaller amounts, in a broader variety of industries (not just high-tech), and accept lower rates of return on equity. Their exit strategy is through public offerings, private sales, or stock buy-backs with retained earnings. Like most equity capital funds, they also provide technical assistance. For example, a fund may be established that targets minority entrepreneurs in the hospitality and convention service industry, if they are willing to locate in the region's lower-income communities, some of which are conveniently located near the convention center, downtown tourism zones, and central city hotels.

Financial counseling was strongly recommended among organizations interviewed, for both homebuyers and small businesses. Many believe that counseling would help people who would qualify under existing programs, but who are not aware of how to apply. In this respect, counseling programs may be the most cost effective to implement. Programs exist in a variety of forms at chambers of commerce, community colleges, government agencies, etc. The main criticism regarding these programs is that they do not adequately maintain a physical presence in the communities that need these services the most, or that they are under-funded. Financial counseling centers, or, at a minimum, temporary centers with limited office hours, may be established in selected locations within low- and moderate-income communities to help existing counseling organizations maintain a presence in these communities.

Affordable housing trusts or land trusts are established to provide timely financial resources to facilitate the development of affordable housing. The trust funds are used to leverage other sources of funds to complete the financing of a project. The funds play a key catalyst role. While the City of San Diego has a Housing Trust Fund, its funding sources have been diminished, and it only serves the City of San Diego. A land trust could be a private, non-profit trust. Similar to land trusts for open space preservation, the trust could secure properties for affordable housing when they are available, then sell them to a developer of affordable housing when the developer's financing is in place.

Community-based development organizations exist in various forms in some of the region's older, urban communities. These private non-profit organizations include development corporations, service organizations, business improvement district organizations, merchants associations, and other entities. They are the organizations that are most active in the day-to-day business of community development, and are familiar with the peculiar opportunities and constraints in their respective communities. Their organizational, financial, and technical capacity, however, varies considerably.

Variations of these organizations and structures already exist in the region in some form. For example, the Neighborhood Development Bank is a community-based development bank. Accion is an intermediary micro-loan lender. SEDC and the City of San Diego have public small-business loan funds, and several cities have affordable housing loan funds. EMTEC is a targeted public loan fund with equity warrants. The Small Business Development Centers provide small business financial counseling, while others provide homebuyer counseling programs. The City of San Diego has a housing trust fund. Mid-city has a development corporation and several business improvement districts. Some of these existing programs are relatively new, some have had success but with a limited scope, and some have under-performed.

Most of these organizations and structures in the San Diego region are in place in some areas of the region. Many of these organizations and structures, however, are relatively young compared to similar organizations in some other major cities, and have not yet had the time or resources to demonstrate their effectiveness. The RTF should work with these existing organizations and financial institutions first to determine if the above recommendations can be implemented by enhancing existing organizations and structures, or by creating new ones to effectively serve the RTF's goal of bringing greater reinvestment to the region's low- and moderate-income communities.